

CBO TESTIMONY

**Statement of
David B. Newman
Principal Analyst
Budget Analysis Division**

The Air Force's Proposal for Procuring F-22 Fighters

**before the
Subcommittee on AirLand
Committee on Armed Services
United States Senate**

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Mr. Chairman, Senator Lieberman, and Members of the Subcommittee, I am pleased to appear before you today to discuss the Air Force's acquisition strategy for the F-22 fighter program. At your request, the Congressional Budget Office (CBO) has examined the proposal for a multiyear procurement contract for 60 aircraft, focusing specifically on the additional material that the Air Force submitted to the Congress after the Subcommittee's hearing on this matter on March 28, 2006.

When the Air Force proposed a multiyear procurement contract for 60 F-22As in February as part of the President's budget request for fiscal year 2007, it had not completed the analysis required by the statute that authorizes multiyear procurement (10 U.S.C. 2306b) to determine whether such a contract would result in "substantial savings" compared with the cost of procuring the aircraft through a series of annual contracts. At the request of the Department of Defense (DoD), the Institute for Defense Analyses (IDA) completed that analysis in May, in which it determined that procuring those aircraft through a multiyear contract could save \$235 million, or about 2.2 percent of the estimated \$10.8 billion cost of procuring those aircraft through three annual contracts.^{1,2}

After reviewing the material provided by the Air Force, I offer the following observations:

- The estimated savings from procuring the 60 F-22As through a multiyear contract are smaller in percentage terms than the savings estimated for other aircraft procurement programs.
- The Air Force does not intend to set aside funds to cover potential cancellation costs for the multiyear contract. It also has not requested funding to cover the full cost of the 60 aircraft that it will commit to buy when it signs the contract. Thus, if the requested funding is provided, the funds available to the Air Force for the F-22A procurement contract will be less than the government's minimum liability.
- The savings from procuring F-22As through a multiyear contract could differ from the amounts estimated because of the uncertainty inherent in such estimates.

1. The cost of procuring the aircraft includes the costs of separate contracts for the air vehicles and the engines, as well as support expenses and other costs.

2. In the budget justification documents submitted in May, the Air Force indicated that the amount of funding it intended to request for the F-22A program in the Future Years Defense Program for the 2007-2011 period would be sufficient to purchase only 56 aircraft and that an additional \$674 million would be required to purchase all 60 planes envisioned in its multiyear procurement proposal. If that additional funding was not available, IDA estimated that the Air Force could save \$225 million by procuring 56 aircraft through a multiyear procurement contract.

Comparison with Other Multiyear Procurement Programs

The estimated savings from a multiyear procurement contract for F-22As are relatively small—as a percentage of contract costs—compared with the savings estimated for other multiyear procurement contracts for aircraft programs. For example, the Navy estimated that the multiyear contract to procure 210 F/A-18 E/F/G fighter/attack aircraft over the 2005-2009 period would save 11 percent compared with a series of annual contracts for those aircraft. In pursuing a multiyear contract to procure 80 C-17A intertheater transport aircraft over the 1997-2003 period, the Air Force anticipated savings of 5 percent in comparison with the cost of a series of annual contracts. Estimates of savings from multiyear contracts for other aircraft procurement programs, such as those for the C-130 cargo aircraft, the F-16 fighter, and the UH-60 helicopter, were between 5 percent and 11 percent.

The savings that could accrue from a multiyear procurement for the F-22A are lower than estimates for other programs for two reasons. First, the Air Force has already undertaken many cost-reduction initiatives prior to proposing the multiyear contract for the F-22A. A substantial portion of the savings that the military services expect to realize from multiyear procurement contracts is derived from investments in equipment, facilities, materials, and techniques that improve the efficiency and reduce the cost of production processes. However, because the F-22A has turned out to be much more expensive than other fighter aircraft—procuring 182 aircraft will cost an average of \$185 million per plane—the Air Force has already funded many cost-reduction initiatives during the development phase and initial production in an effort to hold down total costs.³ As a result, few such initiatives remain to be funded as part of the proposed multiyear contract, reducing the savings available from that acquisition strategy.

A second explanation for the lower estimated savings is that the Air Force would buy fewer planes under the proposed multiyear contract for the F-22A than were procured under other aircraft programs. The Navy plans to purchase a total of 432 F/A-18 E/F/G aircraft by the time it completes a second multiyear procurement contract for those aircraft in 2009. The Air Force purchased 1,830 F-16 fighters under three sequential multiyear contracts over the 1982-1993 period. It also will acquire a total of 140 C-17 aircraft by the time it completes the second multiyear contract for that program next year. Because relatively few F-22A fighters remain

3. The average procurement cost for each annual production lot has declined over time as the production process becomes more efficient. The Air Force will pay an average of \$157 million per plane for the 24 aircraft it ordered this fiscal year. However, the average procurement cost of aircraft ordered in the next three production lots is expected to increase to about \$175 million because the Air Force will procure those planes at a slower, less cost-effective rate of 20 aircraft each year.

to be procured under current plans—the Air Force has already ordered 122 of the 182 aircraft it intends to buy—the opportunity for savings is limited.

Budgeting for Multiyear Procurement

CBO's testimony before this Subcommittee in March focused on two issues regarding the Air Force's acquisition strategy for the F-22A—incremental funding and unfunded cancellation liability. The Air Force had requested the authority to budget and pay for each annual production lot incrementally over a two-year period rather than obtaining appropriations for the full cost of those aircraft in the year production was to begin. That plan would have reduced the amount of budget authority needed in the first year, although it would have increased the amount needed in subsequent years. Incremental funding might constrain the funding available for other programs in future years as programs that were partially funded in previous years continue to require the appropriation of budgetary resources. Because it does not display the full cost of decisions at the time they are made, incremental funding might also limit transparency and accountability and tilt the playing field in favor of expensive programs that benefit from such a funding arrangement. Because the Committees on Armed Services and Appropriations in both Houses disapprove of using incremental funding for the F-22A, the Air Force has indicated that it will submit a proposal to fully fund each annual lot of aircraft before that lot enters production.⁴

Under a multiyear contract, the government may, at the end of each fiscal year, cancel its order for all remaining years of the contract if it notifies the contractor that funds are not available to proceed for the next fiscal year. Thus, cancellation of a multiyear contract occurs between fiscal years if the Congress does not provide the additional appropriations needed to continue. In such a contract, some nonrecurring costs may be allocated to items expected to be produced in future years. Therefore, if the contract is canceled, the government may owe the contractor more than the amount appropriated for items produced in the years before the cancellation. The maximum liability for cancellation at the end of any given year is usually negotiated up front and included in the terms of the contract.⁵

4. The committee reports accompanying the defense authorization and appropriation bills for 2007 indicate that funding will be provided for the full cost of the aircraft before they are ordered.

5. The maximum cancellation liability is known as the cancellation ceiling. Contract cancellation differs from contract termination. The government has the right to end any contract early, when doing so is in the government's interest, but must pay the contractor for any authorized work performed before it was notified to cease work. Contract termination is the act of rescinding orders for items for which funds have already been appropriated and on which work has already begun. The cost of terminating an annual procurement contract early should not exceed the available appropriations because an agency should have sufficient appropriations to cover all recurring and nonrecurring costs before it initiates an annual procurement contract.

In the budget justification material that the Air Force submitted in May, it estimated that the multiyear contract for the F-22A could include a cancellation ceiling of approximately \$200 million in the first year of the contract—approximately the same as the estimated savings from using such a contract. The Air Force does not intend to dedicate budget authority for that liability at the time it is incurred.

DoD does not request budget authority specifically for cancellation liability because it considers cancellation a contingent liability with only a remote probability of happening.⁶ Although the amount of the government's actual liability depends on how the program proceeds, its minimum liability is the sum of the production costs for the items ordered in the first year and the cancellation costs at the end of that year. Regardless of whether the multiyear procurement contract proceeds for the full term or is canceled early, the government's initial obligation to the contractor will exceed the amount required to pay for the items ordered in the first year. For example, after the first year of the three-year contract proposed for the F-22A, the Air Force could either cancel the remaining two years of production and pay the costs for cancellation, or it could continue production for the second year and pay for the cost of those aircraft. Under the multiyear contract, the Air Force would not have the option of forgoing future production lots without paying the cancellation charge. Thus, in no case would the government pay only the cost of the aircraft produced in the first year. An appropriation that covered only the cost for each annual production lot as it was manufactured would therefore be insufficient to finance the government's minimum obligation under the multiyear contract.

The Air Force indicates that it may be able to pay contract cancellation costs with funds appropriated for procuring the F-22A, which suggests that there would be sufficient funds to pay both the cost of canceling future production lots and the cost of procuring the aircraft that had been ordered up to that point. However, if that were the case, the Air Force would be committing the same appropriations for both purposes simultaneously. But with no funds set aside specifically for cancellation costs, the Air Force would have to terminate orders for some of the aircraft that had already entered production if a decision was made to cancel subsequent orders. Thus, if it canceled the remaining years of the multiyear contract at the end of the first year, the government not only would forgo the aircraft to be produced in later years but also would not receive some of the planes it had ordered in the first year—and the taxpayers' investment in those aircraft would be lost. In particular, if the government decided to cancel the contract at the

6. DoD is authorized by 10 U.S.C. 2306b to pay cancellation costs from funds originally available for the performance of the contract, appropriations currently available to procure the type of property at issue (in this case, other aircraft) and not otherwise obligated, or funds appropriated for cancellation payments.

end of the first year but had not set aside funds specifically for cancellation costs, it would not only forgo the 40 aircraft that had not entered production, but, to free up funds for cancellation costs, also have to stop work on some of the 20 aircraft that had already been ordered. Alternatively, the Air Force could divert funds appropriated to procure a different aircraft to pay the cost of canceling the contract for the F-22A. However, to make such funds available to pay cancellation costs, the Air Force would have to buy fewer of that other aircraft.

DoD's failure to request funding for cancellation liability may distort the resource allocation process by understating the cost of decisions made for the budget year and may require future Congresses to find the resources to pay for decisions made today.

Issues for the Congress

Neither the estimated savings nor the cancellation liability is large relative to the cost of the Air Force's proposed multiyear contract to procure the remaining F-22A aircraft. The Congress must weigh the potential for savings against the risk that additional funds will have to be provided if the contract is canceled. It must also consider that, by authorizing DoD to commit to additional purchases in subsequent years, it will reduce budgetary flexibility in those years, as past commitments make resources unavailable for other requirements.

When considering those risks and benefits, it is important to note that estimates of savings from such contracts are inherently uncertain. The savings that might be realized from a multiyear procurement strategy are based on estimates of the costs of the two alternate approaches—multiyear procurement and annual contracts—made at the time the multiyear contract is proposed. Because DoD pursues only one of those approaches, there are no actual data for a comparison of the costs to determine if savings are realized. In this particular case, some of the cost-estimating relationships that IDA used to calculate the savings associated with several aircraft components are not strong. The savings could be significantly different from what has been estimated.

The statute authorizing multiyear procurement contracts requires that such contracts result in "substantial savings" but does not quantify in either dollars or percentage terms a threshold for meeting that requirement. Therefore, the Congress will have to judge whether the estimated savings for the F-22A program are sufficient to compensate for the risk that additional appropriations will be necessary if the contract is canceled and for the loss of budgetary flexibility that it will face.